

## Brave new world for the pound?

### Decisive action needed to ensure UK debt burden on a secure downward trajectory

Cormac Naughten examines the implications of the UK election result and the newly formed Conservative/Liberal Democrat government for sterling

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With the UK mired in its worst ever budgetary deficit and tentatively recovering from the worst recession in recent memory after the worst financial crisis since the Great Depression, the recent UK election was billed as the most important in a generation. With a backdrop of so many “worsts” it certainly managed to produce a lot of “firsts” - the first ever televised leaders’ debates, the first hung parliament since 1974 which, in turn, ultimately led to the first ever Conservative-Liberal Democrat government.

After several years, which have seen what have been described as sterling’s worst declines since the 1930’s, the question in many investors’ minds is: what influence will the new government and its policies have on sterling’s value and how much will the pound’s valuation be driven by external factors beyond its control?

#### Market reaction

Between the election results becoming clear on 7th May and the eventual announcement of the new government on 12th May there was what the Economist referred to as “five days of deal making and denunciation”. Uncertainty was the hallmark of this period of political horse trading with the dramatic announcement by Gordon Brown in front of 10 Downing Street that he

was stepping down as leader of the Labour Party shortening the odds at one point that a multi-party “coalition of the losers” might even take power. As it was the Conservative-Liberal Democrat coalition, whilst regarded by some as the “second best” outcome to a Conservative government with a clear working majority, was seen by the markets as the best outcome given the uncertain electoral picture.

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In the run-up there had been dire speculation from some quarters that a hung parliament and the attendant uncertainty would see the pound go into freefall against most major currencies. In the event, as far as sterling was concerned, the market reaction over the following week was fairly muted. In this period the pound traded within a fairly limited range against both the US dollar and the euro - broadly 1.45-1.50 and 0.84 - 0.88 respectively.

Additional signs of market confidence, despite the then ongoing Conservative/Liberal Democrat negotiations, could be seen in the market response to the auction of 2027 gilts just after the election. There was actually greater demand than when these gilts were last auctioned in August last year with £2.25 billion in bonds sold and the auction twice covered with one anonymous market maker quoted by the FT as saying “The bonds flew out of the door”.

Furthermore, the two leading ratings agencies, Moody’s and Standard & Poor’s, stated that the hung parliament would make little difference to their decision on the UK’s credit rating. They stressed that, rather than the complexion of the new government their primary concern was the ability of the new government to address the nation’s public finance issues. As Standard & Poor’s stated, “Our focus is on whether the

government’s fiscal consolidation plan...is likely or not, in our view, to put the UK government debt burden on a secure downward trajectory over the medium term.”

#### What happens next?

Arguably then the real test for the pound is not the election result itself but what happens next. As highlighted above in Standard & Poor’s comments, the crucial question facing the new government is tackling the shortfall in the UK’s public finances. The key for sterling was not so much the actual composition of the government itself, but a demonstration of the intent to take decisive action to rein in the budget deficit. Early indications point to £6 billion in spending cuts with fiscal tightening through changes in Capital Gains Tax (CGT) and inheritance tax and a potentially significant increase in VAT. With the announcement of the UK Budget on 22nd June we will soon see exactly how the new government will face the challenge regarding fiscal policy and the precise blend of tax increases and spending cuts over the medium term which will be proposed.

#### External influences

The relatively muted market reaction to the new UK government could be attributed to the fact that the eurozone debt crisis and recent slides in global equities - in particular the “flash fall” on the Dow Jones on election night - were a much more important focus for investors and traders than the UK election itself. The focus on Greece has been a background chorus which ultimately took centre stage. It has been pertinent as commentators have compared the UK’s position to that of Greece, noting the scale of our own government deficit and that the IMF has estimated that Britain is set to have the worst structural budget deficit in the G-20 area this year. Key differences are that the net debt/GDP ratio at 70% is not as bad as Greece (115%) and that the UK has a flexible currency rather than being tied into the Euro, which has allowed the UK to benefit from depreciation in the pound to recover competitiveness.

This depreciation has been significant, with sterling still some 20%+ off its pre-crisis highs on a trade weighted basis. RBS, in its latest monthly outlook, are amongst those who note sterling's current "cheapness". They feel that, with the pound at its cheapest in real terms for thirty years against the G10 currencies, "the biggest kicker" behind sterling gains could come from its currently stretched valuations and that, as UK assets are undoubtedly cheap on a multi-year basis, this will eventually attract buyers.

### The Bank of England

Many would feel that significant and durable sterling gains will only come once the Bank of England (BoE) starts to prepare the markets for higher interest rates. However, BoE Governor Mervyn King - ever the optimist - feels that we are only half way through the financial crisis and in his dovish comments accompanying the latest BoE Inflation Report has made it clear that interest rates are going to remain lower for longer than previously expected.

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The unexpected rise in the UK inflation rate to 3.7% in April from 3.4% has prompted questions as to whether the fact that previous weakness in sterling has also contributed to the pick up in

inflation, which might cause the BoE to change its tune towards the exchange rate. Previously the BoE has seemed quite relaxed about weakness in the exchange rate, as they saw it as helping to rebalance the economy as well as providing stimulus. Some commentators have wondered whether the rise in inflation will make the BoE less inclined to let the pound continue to slide. The dilemma that they face regarding monetary policy is that, whilst increasing quantitative easing (QE) appears to be off the agenda, any increase in interest rates to dampen inflation would have a deadly effect alongside the expected tightening of fiscal policy. This leaves the option of a stronger pound as the only mechanism to dampen inflation pressures. One of the only ways they could achieve this would be by talking the pound up or by signalling that an expansion of QE will not happen. As noted above, sentiment and positioning towards the pound has been extreme so, should this happen, there is the possibility of a revival. Even if it were not huge it could signal that the period of extensive declines in sterling is behind us.

### Consolidation?

Interestingly, since the start of 2009, on a trade weighted basis sterling has been broadly steady (although there has been greater volatility against particular currencies over that period).

The process of consolidation in the exchange rate can continue if the markets give a positive response to the next Budget. As always, there will be a large number of factors outside the ambit of government policy that will determine sterling's progress over the next 12 months, such as interest rate policy, the role of the Bank of England and ratings agencies. Ultimately though, one of the main drivers will remain the markets' confidence in the new government's handling of the UK budget deficit.

How they manage the balancing act of acting decisively without imperilling the nascent recovery will be crucial. Too much emphasis on tax increases could discourage economic growth whilst it is also important to avoid "slash and burn" policies in which draconian budget cuts inadvertently backfire by generating a reduction in economic growth and a subsequent deterioration in the budget deficit. Although all eyes and TV cameras seem to have been on Greece recently, there are lessons elsewhere in the eurozone. Ireland has already suffered this fate, where the economy has contracted by 20% but the budget deficit has actually worsened. Without a platform for sustainable growth the process of consolidation in the sterling exchange rate could prove short lived. ■

*This article has made use of material produced by Neil Mackinnon, ECU Group's senior economic advisor and global macro strategist at VTB Capital. Some of the themes contained in the article can be explored in greater depth in Neil's daily Blog at [www.ecugroup.com/resources/MarketCommentary.cfm](http://www.ecugroup.com/resources/MarketCommentary.cfm)*

